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Treatment of Islamic financial instruments

Treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries

Note by the Working Group on Treatment of Islamic Financial Instruments**

I. Introduction

1. At the third session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 29 October to 2 November 2007, it was decided that the subcommittee would prepare a short general description in relation to other arrangements that would cover returns from Islamic financial instruments for the commentary, as well as a more extensive version for the manual. The purpose of the present paper is to propose such a general description in relation to Islamic financial instruments, to be added to the commentary on article 11.

II. Proposed commentary

2. The following commentary relates to the first part of the definition of interest (art. 11, para. 3, first sentence). Therefore, it fits properly after paragraph 21.1 of the Organization for Economic Cooperation and Development (OECD) commentary on the same paragraph, and its four paragraphs (see below) would be numbered 21.2 to 21.5 if they were added to the OECD commentary. But since they will be added only

* E/C.18/2008/1.

** The views and opinions expressed in the present note are those of the subcommittee on exchange of information (coordinator: Moftah Jassim al-Moftah) and do not necessarily represent those of the United Nations. Please also refer to the paper considered at the previous session (E/C.18/2007/9).

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to the commentary of the United Nations model, we propose to insert them after the reference to paragraph 21.1 of the OECD commentary, to number them 20.1 to 20.4 and to resume the OECD commentary in a new paragraph 21, which would reproduce paragraphs 22 and 23 of the OECD commentary.

3. The proposed commentary is as follows:

20.1. Furthermore, in a number of countries, certain non-traditional financial arrangements are assimilated to debt relations under domestic law, although their legal form is not a loan. The definition of interest in paragraph 3 applies to payments made under such arrangements.

20.2. The above applies, for instance, to Islamic financial instruments where the economic reality of the contract underlying the instrument is a loan (even if the legal form thereof is not). This may be the case, for example, of *murabaha, istisna'a*, certain forms of *mudaraba* and *musharaka* (i.e., profit-sharing deposits and diminishing *musharaka*) and *ijara*[1] (where assimilated to finance lease), as well as *sukuk* based on such instruments.

20.3. Countries that do not deal specifically in their domestic law with the above-mentioned instruments and generally follow an economic-substance-based approach for tax purposes may, nevertheless, apply the definition of interest to payments made under those instruments. Alternatively, such countries, as well as those following a purely legal approach for tax purposes, may wish to refer expressly to such instruments in the definition of interest in the treaty. This may be done by inserting the following after the first sentence:

> "The term also includes income from arrangements such as Islamic financial instruments where the substance of the underlying contract can be assimilated to a loan".

20.4. It is clear that the above does not apply to Islamic financial instruments the economic substance of which cannot be considered as a loan.

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[1] For more details regarding these instruments, see the negotiation manual.